

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE
STATE OF CALIFORNIA**



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Order Instituting Rulemaking to Implement the)
Commission's Procurement Incentive Framework)
and to Examine the Integration of Greenhouse Gas)
Emission Standards into Procurement Policies.)
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R.06-04-009
(Filed April 13, 2006)

**COMMENTS OF CALPINE CORPORATION ON
THE MARKET ADVISORY COMMITTEE RECOMMENDATION FOR
DESIGNING A GREENHOUSE GAS CAP-AND-TRADE SYSTEM FOR CALIFORNIA**

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Pursuant to the July 19, 2007 ruling of Administrative Law Judges TerkKeurst and Lakritz ("ALJ Ruling"), Calpine Corporation ("Calpine") submits these comments on the Market Advisory Committee ("MAC") recommendation of a "first seller approach" for designing a greenhouse gas ("GHG") cap-and-trade system for California (the "MAC Report"). The MAC's objective is to design a cap-and-trade program that will result in cost effective GHG emissions reductions consistent with the goals of Assembly Bill ("AB") 32. The first seller approach represents an alternative to the load-based approach jointly being studied by the California Public Utilities Commission ("CPUC") and the California Energy Commission ("CEC") for regulating GHG emissions in the electricity sector.

I. INTRODUCTION

As Calpine has discussed in previous comments filed in this proceeding, it strongly supports the GHG emission reduction goals established in AB 32 and the efforts of the CPUC, CEC, MAC, and the Air Resources Board ("ARB") to design and implement a fair, workable, market-based approach to meet these goals. Calpine believes both the first seller and load-based approaches have inherent strengths and weaknesses. Whether one approach or the other is

ultimately successful in reducing GHG emissions, however, will depend, in large part, on implementation details yet to be formulated and adopted.

Given current unknowns, Calpine's comments do not take a position as to which approach is superior or should be adopted; but rather, generally address the issue areas identified in the ALJ Ruling.¹ In addressing these issue areas, Calpine focuses on a few "core concepts" that it believes are critical components to a successful cap-and-trade program and should inform the decision making process in general, and consideration of the specific issues raised in the ALJ Ruling in particular. These core concepts include:

- Clear and enforceable emissions caps where emissions are fully verifiable;
- Strong reporting, tracking, and verification mechanisms that will minimize the need for emission proxies;
- An approach to distributing emissions allowances (whether by allocation or auction) that minimizes significant adverse economic impacts and "links" allowances to the entities responsible for GHG emissions compliance; and
- A liquid, transparent and administratively efficient market for emissions allowances that recognizes and rewards early actors and technical innovation.

While these core concepts do not represent a definitive and complete list of components necessary to develop a successful cap-and-trade program, Calpine believes they are integral to achieving the emissions reduction goals set out in AB 32.

II. DISCUSSION

A. Basic Definitions (Questions 1-8)²

The description of the first seller approach used in the ALJ Ruling appears to be consistent with the definition used in the MAC Report. Specifically, for in-state resources, the

¹ Calpine generally supports the comments being filed by the Western Power Trading Forum ("WPTF"). WPTF provides responses to specific questions contained in the ALJ Ruling.

² Section headings (including numbering) correspond to section headings in the ALJ Ruling. Calpine has not included section headings for issues in which it is not providing comments.

first seller is the generator in all cases and, for imports, the first seller is the entity that first delivers electricity at a point of delivery within California – in other words, the Purchasing/Selling Entity (“PSE”) listed on the NERC E-tag at the first California point of delivery. With respect to imports, this PSE could be the generator, a marketer, or some other entity, such as a retail provider that has taken title to the power out-of-state.

In cases where the PSE is not the actual generator, or the source of the power is not known (*i.e.*, an “unspecified” source), it may be necessary to assign a “proxy” emission level under both the first seller and load-based approaches, notwithstanding the use of E-tags. This would be the case because, in some instances, E-tags only track back to a control area and not the specific generating source, making it nearly impossible to determine actual emission levels for use in determining compliance with an AB 32 cap-and-trade system. In addition, under a load-based approach, greater use of proxies may also be needed for certain in-state power deliveries because, unlike the first seller approach, the point of regulation under a load-based system is not at the generator.

As discussed in more detail below, the widespread use of emission proxies can undermine efforts to achieve long-term emissions reductions. Thus, accurate emissions tracking will be critical to the success of either a first seller or load-based approach. Accordingly, Calpine supports the adoption of strong and accurate reporting and tracking protocols, as well as policies that minimize the use of emission proxies.

B. General Policy Issues (Questions 9-16)

Leakage and contract shuffling are a concern under both the first seller and load-based approaches. With respect to leakage, under either approach, the use of emission proxies (or default emission rates) for any out-of-state power provides an opportunity for entities to shift from lower emitting in-state sources to higher emitting out-of-state sources, potentially resulting

in increased emissions associated with California energy use. One possible way to discourage such leakage would be to adopt high emission proxy rates for unspecified sources. Adopting high proxy rates should encourage lower emitting sources to identify and report emissions associated with energy production and help prevent higher emitting sources from gaming the system by marketing their power as “unspecified.” Under this approach, actual emission levels can be more accurately tracked and reported for AB 32 compliance purposes.

Contract shuffling is also a problem under either approach. Contract shuffling refers to a situation where an entity “shuffles” contract commitments so that higher emitting resources are used to serve load outside California and cleaner resources are used to serve demand in California. “Shuffling” contracts may provide a way for regulated entities to be “technically” in compliance with California’s cap-and-trade program notwithstanding that there would be no “net” reduction in emissions.

In addition, unlike leakage, contract shuffling could become more pervasive as policies result in an increased use of specified sources. Specifically, to maximize the value of their portfolios, power importers will have an incentive to specify low-emitting sources of power for import into California (in order to meet cap-and-trade obligations) and market higher-emitting power in other states. This would be the case because, under a single-state cap-and-trade program, there is no effective way to dictate or regulate the dispatch of out-of-state generation. As a result, contract shuffling can occur whenever power is imported into California and the potential for it will likely exist under any California only approach to emissions reductions.

Irrespective of the approach (first seller or load-based), leakage and contract shuffling are problems inherent in single-state cap-and-trade programs. Both of these problems, however, can be effectively addressed through robust regional or national programs that include strong reporting and tracking requirements.

E. Reporting, Tracking, and Verification (Questions 26-31)

Irrespective of whether a first seller or load-based approach is adopted, strong reporting, tracking, and verification mechanisms will be necessary if mandated GHG emissions reduction is to be achieved. AB 32 requires ARB to develop reporting protocols that will “[a]ccount for greenhouse gas emissions from all electricity consumed in the state.”³ At a minimum, accurate accounting of emissions requires source identification and tracking. Absent initial identification of the source providing power, it will be nearly impossible to determine and verify associated emissions for AB 32 compliance purposes. Given the role played by marketers, title to power can often change hands multiple times before entering the State (which is relevant under a first seller approach) or reaching end-use customers (which is relevant under a load-based approach). Thus, once a source is specified, it is equally important that the power be carefully tracked as new entities acquire title, or it moves across the grid.

Requiring that all sources of electricity be specified would be the most effective and accurate way to account for emissions. Nevertheless, there will likely be a continued need for some unspecified resources to ensure reliability under California’s current market structure. As a result, some type of emission proxy will need to be developed.

By their nature, emission proxies are problematic in the context of cap-and-trade programs because they do not directly link a source with its assigned emissions. As a result, if a proxy is lower than the actual emissions of the source to which the proxy is applied, accounting protocols will necessarily understate actual emissions. Moreover, under such circumstances, higher emitting sources will have an incentive to market themselves as unspecified resources to take advantage of the lower emissions proxy level. The net effect is that *actual* emissions may

³ Cal. Health and Safety Code §38530(b)(2).

be higher than reported emissions, notwithstanding that all responsible entities are in compliance with their respective obligations under an AB 32 cap-and-trade program.

To better ensure the goals of AB 32 are met, Calpine supports the adoption of strong reporting, tracking, and verification mechanisms that minimize the need for emissions proxies. Calpine firmly believes that such mechanisms will be critical to the success of either a first seller or load-based cap-and-trade program.

F. GHG Emissions Allowance Allocation Issues (Questions 32-34)

Emissions allowances could be auctioned or directly allocated under either the first seller approach or the load-based approach. If adopted, an auction approach should contemplate a phase-in period that would include the direct allocation of allowances to some sources in order to mitigate potential adverse economic impacts associated with increased capital costs necessary to comply with emission reduction requirements and/or energy contracts that do not contemplate emission reduction costs. Under this approach, allocations should be based on electricity output - that is, based on energy produced or sold - and updated on a regular basis to account for changes in production and contracting. Basing allocations on electricity sales will make it possible to directly allocate allowances to any entity, whether a physical generating source or a marketer selling under energy contracts. In addition, regularly updating allocations should result in the better matching of allowances with allowance requirements, and will create incentives for efficient, lower emitting resources to operate more which will, in turn, reduce overall GHG emissions. This approach to allocation (energy output with regular updating) should also reduce the risk of windfall profits by reducing the chances of over allocation of allowances.

Calpine does not support any allocation scheme that would be limited only to retail providers and require other first sellers to acquire allowances via auction. To the extent allowances are allocated, retail providers should not be treated differently than other entities

subject to the cap-and-trade program. Specifically, allowances should be allocated to all entities who are regulated under the program, whether a generator, marketer, or retail provider.

Allocating allowances in this way provides an incentive for those subject to the cap-and-trade program to reduce emissions.

Furthermore, under the first seller approach, retail providers would be subject to the cap and trade program for only a small fraction of sales, if at all.⁴ If these entities are over allocated allowances, they could control a large portion of the allowance market with little incentive to make those allowances available to the market. Giving a retail provider more allowances than which it would otherwise qualify for as the first seller could reduce liquidity in the allowance market and, thus, reduce the ability of the market to find the most cost effective means for achieving the state's emission reduction goals. Liquidity and transparency are critical to an efficient market, and allocating allowances only to retail providers under a first seller approach is counter to that goal.

In addition, since some retail providers also own generation, allocating allowances to them and not other entities subject to the cap-and-trade program raises serious competitive concerns. Under both the first seller and load-based approaches, retail providers will potentially be subject to AB 32 compliance requirements at some level. However, given that they compete in the market with other generators and marketers, it would be patently unfair to allow retail providers to manage the auction or allocation process. Liquidity and transferability should be a fundamental principle of the market. Giving allowances to the retail providers for future allocation to other entities, subject to the cap-and-trade program, may jeopardize this principle.

⁴ This would be the case because retail providers generally contract for a significant portion of the energy needed to serve their loads.

H. Relationship to a Multi-State System Such as the Western Regional Climate Action Initiative (Questions 36-39)

Whether there is a risk of double counting the emissions from imported power is dependent on the specific type of cap-and-trade programs involved. For example, should California adopt the first seller approach, the point of regulation for all in-state sources will be the generator. However, if the generator exports power to a state that also employs a first seller or load-based cap-and-trade program, then there is the potential for the emissions associated with the imported power to be double counted – once in California and, then again, when the power is first sold in the other state (if the state employs a first seller approach) or when acquired by a retail provider to serve load (if a load-based approach is used). Given the risks of double counting emissions, it is critical that the most accurate reporting and tracking mechanisms be employed. Accurately reporting and tracking emissions should help identify power that has already been “counted” for compliance purposes in one state so that other states could exempt such power from cap-and-trade compliance requirements.

I. Interaction with Potential Federal Regulation (Questions 40-42)

Whether a first seller or load-based approach can be easily “scaled or linked” to a regional or national GHG emissions program will depend, in large part, on the type of regional or national program being contemplated. For instance, the first seller approach functions similar to a source-based program, particularly with respect to in-state sources (*i.e.*, the point of regulation is at the generator/source). Thus, it is reasonable to assume that the first seller approach would be more easily linked than a load-based program to regional or national source-based systems. By the same token, a load-based program should be more easily linked to any regional or national load-based system.

III. CONCLUSION

Calpine supports the efforts of the CPUC, CEC, MAC, and ARB to design and implement a fair, workable, and market-based cap-and-trade program that will result in cost effective GHG emissions reductions consistent with the goals of AB 32. To accomplish this goal, it will be critical that strong reporting, tracking, and verification mechanisms be adopted that will minimize the need for emission proxies; emissions allowances be distributed in a way that minimizes adverse economic impacts and links allowances to entities subject to emissions compliance obligations; and a liquid, transparent, and administratively efficient emissions allowance market be established.

Respectfully submitted,

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Dated: August 6, 2007

CERTIFICATE OF SERVICE

I, Judy Pau, certify:

I am employed in the City and County of San Francisco, California, am over eighteen years of age and am not a party to the within entitled cause. My business address is 505 Montgomery Street, Suite 800, San Francisco, California 94111.

On August 6, 2007, I caused the following to be served:

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via electronic mail to all parties on the service list R.06-04-009 who have provided the Commission with an electronic mail address and by First class mail on the parties listed as "Appearance" and "State Service" on the attached service list who have not provided an electronic mail address.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration was executed on the date above at San Francisco, California.

_____/s/ Judy Pau_____
Judy Pau

cc: Commissioner Michael R. Peevey (via U.S. Mail and Email)
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CALIFORNIA PUBLIC UTILITIES COMMISSION

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